Dura Pharm., Inc. v. Broudo – *The Least Of All Evils*

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When the Supreme Court granted the petition for writ of certiorari to the Ninth Circuit in *Dura Pharmaceuticals, Inc. v. Broudo* in June 2004, the defense bar expected a lot, and plaintiffs' bar feared the worst. Most expected that the Supreme Court would reject the "price inflation" theory of loss causation, but worried how far the Court would go in granting defendants' and industry amici's "wish list" including requiring a specific corrective disclosure followed by a stock price drop, eliminating the presumption of reliance, and imposing a heightened standard for pleading loss causation. But in the end, the unanimous Supreme Court opinion in *Dura* was not a bad decision for plaintiffs -- defendants got the price inflation theory win, and nothing else, and the plaintiffs' bar ended up with the best of all possible non-prevailing scenarios.

A little background is necessary. Courts have long implied a private right of action for damages under § 10(b) of the Securities Exchange Act of 1934 and SEC Rule 10b-5. To sufficiently plead such a claim, a private plaintiff must allege (1) a material misrepresentation or omission or fraudulent scheme; (2) in connection with the purchase or sale of a security; (3) scienter; (4) reliance; (5) an economic loss; and (6) "loss causation." *See Dura Pharms, Inc. v. Broudo,* 125 S. Ct. 1627, 1631 (April 19, 2005); *see also* 15 U.S.C. § 78u-4; 17 C.F.R. § 240.10b-5(a)-(c). The last two elements were at issue in *Dura*. The controversy arose from the Ninth Circuit's acceptance of pleading artificial price inflation on the date of purchase, as sufficient to allege loss causation. *See, e.g., Dura,* 339 F.3d 933, 938 (9th Cir. 2003). "Because the Ninth Circuit's views about loss causation differ from those of other Circuits that have considered this issue," the Supreme Court granted Dura's petition for certiorari. 125 S. Ct. at 1630. In a concise five-page opinion, Justice Breyer rejected the price inflation theory, finding it "inconsistent with the law's requirement that a plaintiff prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff's economic loss." *Id.* at 1633. Explaining that "[w]e need not, and do not, consider other proximate cause or loss-related questions," however, the Court gave little guidance on what allegations would satisfy the Court's loss causation requirement.

What is notable to securities plaintiffs (and a disappointment to the defense bar) is what the *Dura* decision does **not** say.

No Specific Corrective Disclosure Requirement

Dura does not, for example, adopt the position urged by defendants and their amici, that plaintiff must allege "a corrective disclosure followed by a stock price drop." Pet. Br. at *10. Despite substantial briefing and colloquy about this issue at argument, the Court endorsed neither petitioner's "corrective disclosure" nor its "stock price drop" arguments. Instead, the Court's narrow ruling said only that the Ninth

Circuit's price-inflation-at-purchase theory was "inconsistent with the law's requirement that a plaintiff prove that the defendant's misrepresentation (or other fraudulent conduct) proximately caused the plaintiff economic loss, and that an "'artificially inflated purchase price' is not itself a relevant economic loss" in a § 10(b) action. 125 S. Ct. at 1634. *Dura* does not foreclose establishing loss causation by means other than a specific corrective disclosure of the truth linked to a stock price drop.

Had the Court adopted defendants' proposed requirement of a specific corrective disclosure of the truth – by confession or otherwise – linked to a drop in stock price, the pleading hurdle could have been "insurmountable." [Resp. Br. at *9.] Plaintiffs argued that "[s]ophisticated individuals who would commit market manipulation and fraud are likely to be adept at concealing it. Expectations can be lowered, thereby reducing fraud-induced inflation without disclosure of the fraud, by further false statements. Even the passage of time itself will dissipate a fraud's impact on a stock's price."[2] Indeed, it is not unusual for a company with a problem to strategically leak multiple negative information at different times, or to combine negative events and disclose them at once to confound plaintiffs' ability to isolate the cause of their losses. In many complex cases, the full extent of the fraud is not revealed until long after the stock price collapses.

There are myriad ways in which the truth may be revealed, for example: 1) whistleblower claims; 2) analysts question financial results or other company "explanations"; 3) CFOs or auditors resign; 4) the company lowers earning expectations; and/or 5) the company announces changes in accounting treatment going forward. *See* John C. Coffee, *Loss Causation After 'Dura': Something for Everyone*, N.J. L.J., May 19, 2005 (explaining that requiring a "disclosure of corrective information" "ignores that the market can learn of fraud or suspected fraud well before a formal corrective disclosure").

Nothing in *Dura* precludes plaintiffs from pleading loss causation through a ***partial*** disclosure. Indeed, as a recent decision interpreted *Dura*: "plaintiffs need only allege 'that the misstatement or omission concealed something from the market that, when disclosed, negatively affected the value of the security,' and loss causation does not require *full* disclosure and can be established by *partial* disclosure during the class period which causes the price of shares to decline." *Montoya v. Mamma.com Inc.*, 2005 WL 1278097, at *2 (S.D.N.Y. May 31, 2005) (citing *Dura* and *Lentell v. Merrill Lynch & Co.*, 396 F.3d 161, 174 (2d Cir. 2005)) (emphasis in original).[3]

In its first post – *Dura* decision, the Ninth Circuit implicitly rejected defendants' position that *Dura* requires that the revealed "truth" must precisely mirror the specific allegations in the complaint. In *Daou Systems*, defendants argued that the complaint did not allege that the truth "about the Company's alleged violation of the [percentage-of-completion] method" became known when the stock price fell, but the Ninth Circuit held the complaint sufficiently alleged loss causation because it alleged the company's stock fell precipitously "*after defendants began to reveal figures showing the company's true financial condition*." *In re Daou Systems, Inc.*, 2005 WL 1431833, at *15-*16 (9th Cir. June 21, 2005).

No Price Decline Requirement

The Supreme Court also did not adopt defendants' argument that a "loss" can only occur when the stock price ***declines,*** and not when the stock price experiences an overall net increase due to, for example, the mixed disclosure of both negative and positive information. Pet. Br. at *13, *36. The untruth will ***generally*** be removed through an absolute decline in the price of the security, ***but could also be removed through an increase in the price that is smaller than it otherwise would have been***. The *Dura* court acknowledged that when "a share's higher price is lower than it would otherwise have been," the same reasoning applies as does when a purchaser subsequently resells shares at a lower price.[4]

Likewise, *Dura* does not require plaintiff to demonstrate that the entirety of their economic loss was caused ***exclusively*** by defendants' fraud. Indeed, *Dura* emphasizes that loss causation deals with the concept of proximate cause, drawn from common law principles. *See Dura,* 125 S. Ct. at 1631-32. Those principles require only that fraud be a substantial cause of loss – not that it be the exclusive cause. *See Sosa v. Alvarez-Machain*, 124 S. Ct. 2739, 2750 (2004) ("Proximate cause is causation substantial enough and close enough to the harm to be recognized by law, but a given proximate cause need not be, and frequently is not, the exclusive proximate cause of harm."). Thus, the Court also left open the door on ways to allege, and prove, loss.

The Presumption of Reliance Remains

The *Dura* Court also did not accept defendants' invitation to re-evaluate the rebuttable fraud-on-the-market presumption it accepted in *Basic Inc. v. Levinson,* 485 U.S. 224 (1988), by arguing the plaintiffs must also plead *separate* transaction causation. Instead, the Court reiterated that transaction causation and reliance are synonymous in most securities class actions and can be established through the fraud-on-the-market presumption. 125 S. Ct. at 1631; *see also id.* at 1633, 1634.[5]

No Heightened Pleading Standard

Justice Breyer's discussion of the applicable pleading standard is particularly noteworthy.[6] Defendants and their amici argued that loss causation allegations must satisfy the heightened pleading standards of Federal Rule of Civil Procedure 9(b) and the PSLRA. The Securities Industry Association even argued that the PSLRA requires the complaint to include expert testimony supported by "[a]n event study . . . a statistical regression analysis that examines the effect of an event, such as an allegedly fraudulent statement or omission, on a dependent variable, such as a company's stock price." Sec. Ind. Ass'n Br. at 9-10, n.6.

The Court did not adopt these positions, but instead "assume[d], at least for argument's sake, that neither the Rules nor the securities statutes impose any special further requirement in respect to the pleading of proximate causation or economic loss." *Dura*, 125 S. Ct. at 1634. The Court analyzed the loss causation allegations under Federal Rule of Civil Procedure 8(a), requiring "a short and plain statement of the claim showing that the pleader is entitled to relief," which provides a defendant with "fair notice of what the plaintiff's claim is and the grounds upon which it rests."[7]

Applying "ordinary pleading rules" to the complaint before it, the Court, found that "the complaint nowhere else provides the defendants with notice of what the relevant economic loss might be or of what the causal connection might be between that loss and the misrepresentation . . . ." 125 S. Ct. at 1634. In apparent guidance going forward, the Court commented, "We concede that ordinary pleading rules are not meant to impose a great burden upon a plaintiff. [citation omitted]. But it should not prove burdensome for a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind." *Id.* at 1634.

***Case Outcomes Remain Unchanged After* Dura**

In the first published circuit court decision to apply *Dura*, the Ninth Circuit in *Daou Systems*, 2005 WL 1431833 (9th Cir. June 21, 2005), reached the same result as it had prior to *Dura*. In its *original* opinion (issued a month after the argument in *Dura*) the Ninth Circuit held that the district court erred in dismissing the complaint for failure to sufficiently allege loss causation. The district court had concluded that Daou's improper use of the percentage-of-completion accounting method was not linked to the decline in Daou's share price and that analysts' suspicions were "merely speculation." *Daou*, 397 F.3d 704, 722 (9th Cir. Feb. 2, 2005). On appeal, the Ninth Circuit found significant that "the price of the stock fell precipitously after defendants revealed figures vastly different than those reported in a press conference two weeks prior. The complaint also anonymously quotes an analyst who allegedly stated, '[w]hen you say one thing on the conference call and report something different on the 10-Q, that raises concern. . . . *You have got to question whether they are manufacturing earnings.*" *Id.* at 722. The Ninth Circuit in its original opinion concluded: "Although some of the allegations do call for speculation, the foregoing, if assumed true, is sufficient to show that the drop in Daou's stock price was the direct result of their financial misstatements and, in turn, caused plaintiffs' damages." *Ibid.*

After the Supreme Court issued its decision in *Dura*, the Ninth Circuit ordered the parties to submit supplemental briefs "addressing the impact of the Supreme Court's decision in [*Dura*] on the opinion in this case." Defendants' argued that the *Daou Systems* complaint "never meets the threshold *Dura* requirement of a moment when the truth became known," because (1) the complaint does not allege a specific date on which the relevant truth became known; and (2) the "truth" that became known must specifically mirror the complaint's allegations that the company violated GAAP through the misuse of the percentage-of-completion method.[8]

On June 21, 2005, the Ninth Circuit issued an Amended Opinion repeating the loss causation paragraphs contained in its original Opinion, and in implicitly rejecting defendants' supplemental arguments. The Ninth Circuit concluded that the alleged facts were "sufficient to provide Daou with ***some indication that the drop in Daou's stock price was causally related to Daou's financial misstatements reflecting its practice of prematurely recognizing revenue before it was earned.*** 2005 WL 1431833, at *16 (citing "*Dura Pharms.*, 125 S. Ct. at 1634 (requiring 'a plaintiff who has suffered an economic loss to provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind')") (emphasis added). The Ninth Circuit also added a new section entitled "Economic Loss":

> ***Plaintiffs' economic loss was not that they purchased stock at inflated prices; rather, their economic loss was the decline in their***

> ***stock value that was the direct result of Daou's misrepresentations***. *See Dura Pharms.*, 125 S. Ct. at 1631-32. Here, the TAC's assertions of a steep drop in Daou's stock price following the revelation of Daou's true financial situation are sufficient to enable the complaint to survive a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

2005 WL 1431833, at *16 (emphasis added).[9]

Judge Scheindlin also re-examined a prior opinion in *In re IPO* in light of *Dura.* In the court's initial opinion issued April 1, 2005 (just 18 days before the Supreme Court's *Dura* decision), the court predicted that "any ruling by the Supreme Court in *Dura Pharms.* will certainly affect the pleading standard for misrepresentation cases like this one." *In re Initial Pub. Offering Sec. Litig.,* 2005 WL 743550, at *6 n.68 (S.D.N.Y. Apr. 1, 2005). But, upon reconsideration after the *Dura* decision was published, Judge Scheindlin noted that "*Dura* itself does not define a pleading standard for loss causation; rather, it simply rejects the Ninth Circuit's standard as overly permissive," and concluded that the Second Circuit's loss causation standard "is undisturbed by *Dura*." 2005 WL 1162445, at *3 n.23 (S.D.N.Y. May 6, 2005). As in *Daou Systems*, the outcome did not change after *Dura*, but the court "supplement[ed]" its loss causation analysis. *Id.* at *4. Using the Second Circuit analysis, in her supplemental opinion Judge Scheindlin found that the complaint's allegations were insufficient because they did not allege that, "at some point, the concealed scheme was disclosed to the market." *Id*. at *3.[10] She continued: "It is illustrative to consider what kind of event could have disclosed the actual fraud alleged, thereby permitting a determination of whether the alleged fraud actually caused any losses," and surmised that a single news article stating, for example, that one of the defendants had engaged in the "common and deceptive practice of deliberately understating a company's expected earnings" in an effort to avoid missing estimates, "could have constituted a disclosing event." *Id.* at *4. But because the complaint alleged no such disclosures, Judge Scheindlin dismissed the complaint. *Ibid.*

The Sixth Circuit reached the same result in an unpublished decision after *Dura*, *D.E. & J. Ltd. P'ship v. Conaway,* 2005 WL 1386448 (6th Cir. June 10, 2005), a case brought against several former Kmart executives and PricewaterhouseCoopers. In affirming dismissal of the complaint, the Sixth Circuit reasoned that the complaint did "not differ in any material respect from Broudo's [in *Dura*]. Like Broudo, [plaintiff] did not plead that the alleged fraud became known to the market on any particular day, did not estimate the damages that the alleged fraud caused, and did not connect the alleged fraud with the ultimate disclosure or loss. Rather, the heart of [plaintiff's] causation theory looks remarkably like Broudo's allegations in his complaint." 2005 WL 1386448, at *5.[11]

The Sixth Circuit rejected plaintiffs' arguments that: (1) their complaint was materially different from the *Dura* complaint because the *Conaway* complaint alleged a stock drop following the company's disclosure that it had filed for reorganization under Chapter 11; and (2) the stock drop following the restatement announcement was sufficient, albeit not alleged in the complaint. The Sixth Circuit rejected both arguments because "[n]either of these observations (one in the complaint, the other on appeal) 'provide[d] the defendants with notice of what the relevant economic loss might be or of what the causal connection might be between the loss and the misrepresentation.'" *Id.* at *6 (quoting *Dura*, 125 S. Ct. at 1634). The court explained: "As to the bankruptcy filing, [plaintiff] never alleged that Kmart's bankruptcy announcement disclosed any prior misrepresentations to the market. . . . And, of course, the filing of a bankruptcy petition by itself does not a security fraud allegation make." *Id.* The court further explained, "[h]ere, [plaintiff] has done nothing more than note that a stock price dropped after a bankruptcy announcement, never alleging that the market's acknowledgment of prior misrepresentations caused that drop." *Id.* at *6.

The court further noted the complaint's failure to allege the five cent drop in Kmart's stock price the day

Kmart announced its restatements on May 15, 2002. Implying that such allegations, if actually alleged in the complaint (rather than merely argued on appeal), would satisfy the pleading requirements, the court commented: "By failing even to note that Kmart's stock dropped in price after the company restated its financial records and by failing to present this argument to the district court, [plaintiff] simply never pleaded that the defendants' alleged misrepresentations caused economic losses on May 15, 2002." *Id.*

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[2] Resp. Br. at *10 (citing, *inter alia*, Jay W. Eisenhofer, Geoffrey C. Jarvis & James R. Banko, *Securities Fraud, Stock Price Valuation, and Loss Causation: Toward a Corporate Finance-Based Theory of Loss Causation*, 59 Bus. Law. 1419, 1443 (2004) and *In re Initial Pub. Offering Sec. Litig.*, 297 F. Supp. 2d 668, 673 (S.D.N.Y. 2003) ("ordinary market forces affect the rate of artificial inflation" because in some circumstances "the normal functioning of the securities

market causes the inflationary effect to dissipate over time")).

[3] *Montoya* addressed *Dura* in the context of competing motions for lead plaintiff. There, certain competing plaintiffs argued that the purported damages of "in and out purchasers" should not be included in computing which movant has the largest financial interest (and is, therefore, presumptively the most adequate lead plaintiff under the PSLRA), because, under *Dura*, none of these losses could be attributable to the fraud. The court noted that "in and out purchasers" "obfuscate loss calculations" but that because under *Dura* only a partial disclosure need affect the value of the security, the court appointed the movants with the largest purported loss, including "in and out purchasers," which, the court noted, were not "unique." 2005 WL 1278097, at *2.

Dictum in the Ninth Circuit's Amended Opinion in *Daou*, discussed *infra*, likewise arguably interprets *Dura* as potentially affecting damage calculations: "We note that, as the TAC currently reads, at the time when Daou began to reveal its true financial health in August 1998, its stock was trading at $18.50 per share and not at the class high of $34.375. The TAC does not allege any revelation of Daou's true financial health prior to August 1998. Thus, as the TAC reads now, any loss suffered between $34.375 and $18.50 cannot be considered causally related to Daou's allegedly fraudulent accounting methods because before the revelations began in August 1998, the true nature of Daou's financial condition had not yet been disclosed." 2005 WL 1431833, at *16. *Dauo*, however, discussed the issue in the context of a motion to dismiss, not in the context of evidence of damages presented at trial.

[4] 125 S. Ct. at 1632. Specifically the Court explained: "If the purchaser sells later after the truth makes its way into the

market place, an initially inflated purchase price *might* mean a later loss. But that is far from inevitably so. When the purchaser subsequently resells such shares, even at a lower price, that lower price may reflect, not the earlier misrepresentations, but changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price. (***The same is true in respect to a claim that a share's higher price is lower than it would otherwise have been – a claim we do not consider here***.)." 125 S. Ct. at 1631-32 (emphasis added).

[5] Indeed, the district court in the District of New Jersey has since relied on the Supreme Court's Opinion in *Dura* in denying defendants' motion to dismiss, stating:

> ***The Court is satisfied that the allegations relating to transaction causation in this short-selling context are sufficient to withstand a motion to dismiss based on loss causation***. . . . Read in the light most favorable to short-selling Plaintiffs, the inference to be drawn from the allegations of the Amended Complaint is that the false financial statements artificially inflated [Lernout & Hauspie] stock, which, in turn, forced Plaintiffs to make cover transactions and incur significant losses. ***Fact-intensive issues related to causation and whether a given misstatement 'substantially contributed' to Plaintiffs' losses . . . are not properly resolved at this juncture***.

Rocker Management, L.L.C. v. Lernout & Hauspie Speech Products N.V., 2005 WL 1366025, at *7 (D. N.J. June 8, 2005) (emphasis added).

[6] Several securities and non-securities cases have since cited *Dura*'s explanation of the appropriate pleading standard. *See, e.g., Rocker Management, L.L.C. v. Lernout & Hauspie Speech Products N.V.*, 2005 WL 1366025, at *7 (D. N.J. June 8, 2005) (citing *Dura*'s standard that the complaint need only "provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind"); *Pfeiffer v. Integrated Fund Servs, Inc.*, 2005 WL 1163998, at *3 (S.D.N.Y. May 18, 2005) ("[t]he federal rules allow simple pleadings and rely on liberal discovery rules and summary judgment motions to define disputed facts and issues and to dispose of unmeritorious claims," citing *Dura*); *Edelberg v. Roberts*, 2005 WL 1006000, at *2 (D.D.C. Apr. 29, 2005) (legal malpractice case citing *Dura* regarding general federal pleading standard); *Allied Van Lines, Inc. v. Gulf Shores Moving & Storage, Inc.*, 2005 WL 1027463, at *1 (M.D. Fla. May 2, 2005) (conversion claim citing *Dura* regarding general federal pleading standard). Several other cases merely cite *Dura* for its recitation of the elements of a § 10(b) claim.

[7] 125 S. Ct. at 1634. Although the Court did not expressly decide the issue, by their terms neither Rule 9(b) nor the PSLRA apply to the loss causation element of a Rule 10b-5 action. Rule 9(b) imposes a particularity requirement in only two specific instances. It states in full: "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity. Malice, intent, knowledge, and other condition of mind of a person may be averred generally." The PSLRA similarly imposes particularized pleading requirements for only falsity (when false statements or omission, as opposed to fraudulent

scheme, are alleged) and scienter allegations, not loss causation. *See* 15 U.S.C. § 78u-4(b)(1), (2); *see also Gebhardt v. ConAgra Foods, Inc.*, 335 F.3d 824, 830 n.3 (8th Cir. 2003) ("The new statute does not change traditional pleading rules with respect to" loss causation). The PSLRA expressly addresses loss causation only in the trial stage: "the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this title caused the loss for which the plaintiff seeks to recover damages." 15 U.S.C. § 78j-4(b)(4). For a scholarly analysis of the interplay between Rule 9(b) and the PSLRA, see Judge Scheindlin's opinion in *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281 (S.D.N.Y. 2003).

[8] Defendants/Appellees/Cross-Appellant's Post-Appellate Brief Addressing The Impact On This Appeal Of The Supreme Court Decision In *Dura Pharmaceuticals, [sic] Inc. v. Broudo*, at 3, 8, *In re Daou Systems, Inc. Sec. Litig.* (9th Cir.) (Nos. 02-56989 and 02-57018).

[9] A district court within the Ninth Circuit after *Dura* likewise found the complaint sufficiently alleged loss causation. In *In re Immune Response Sec. Litig.,* Case No. 01-1237 J (S.D. Cal. June 7, 2005), Judge Napoleon Jones denied defendants' motion to dismiss because, although *Dura* "reversed well-established Ninth Circuit case law regarding what is required to withstand a motion to dismiss on this issue," reviewed under Rule 8(a)(2)'s pleading standard, the complaint contained "the very allegations regarding share price decrease and public exposure to the truth the Supreme Court found lacking in the *Dura* complaint." *Id.* at 44-45. The court continued: "Moreover, the Complaint adequately notifies Defendants of the losses claimed and the causal connection between the losses and Defendants' allegedly fraudulent conduct. Whether the alleged omissions and misstatements actually were the cause-

in-fact of the price of IRC stock raises an issue of fact and, as such, is a question properly reserved for a motion for summary judgment or for the trier of fact." *Id.* at 45.

[10] Judges Stein and Kaplan, also sitting in the Southern District of New York, similarly cited *Dura* but then performed the loss causation analysis pursuant to the Second Circuit's prior decisions. *See Louros v. Kreicas*, 367 F. Supp. 2d 572, 592 (S.D.N.Y. Apr. 25, 2005) (denying summary judgment as to loss causation); *Dresner v. Utility.com., Inc.*, 2005 WL 1185636, at *19 (S.D.N.Y. May 18, 2005) (granting motion to dismiss).

[11] Specifically, the *Conaway* complaint, echoing that in *Dura*, alleged only the following with respect to loss causation:

> Plaintiffs and the Class have suffered damages in that, in reliance on the integrity of the market, they paid artificially inflated prices for Kmart publicly traded securities. Plaintiffs and the Class would not have purchased Kmart publicly traded securities at the prices they paid, or at all, if they had been aware that the market prices had been artificially and falsely inflated by defendants' misleading statements. As a direct and proximate result of defendants' wrongful conduct, plaintiffs and the other members of the Class suffered damages in connection with their purchases of Kmart publicly traded securities during the class period.

Conaway, 2005 WL 1386448, at *5 (quoting complaint).